Japan in the Reiwa Era – New Opportunities for International Investors

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Thank you very much for that kind introduction. It is a pleasure and an honor to be able to give some keynote remarks to set the stage for the distinguished panel to follow. I should start by noting that I am an economist and long-term Japan-watcher, not an equity strategist or someone who gives investment advice.

I am going to focus on the big picture. Japan, a $5 trillion economy, does not get as much attention as it deserves. It is still the third largest economy in the world, with 5.9% of global GDP, using market exchange rates, or the fourth largest if measured in PPP (purchasing power parity) terms, with a share of 4.1%. Japan seriously punches below its weight – if it were a stock, it would be a value stock.

I am going to tell you three things that worry me about Japan and three things that don't. But before doing that, given that the title of the address mentions the Reiwa era, it is worth reflecting for a moment on Japan's experience in the preceding Heisei era, which started on January 8, 1989 and ended on April 30, 2019. A lot happened and Japan changed a lot in those thirty years.

The Heisei era, in economic and financial market terms, took in: the last leg of the asset price bubble of the second half of the 1980s; the bursting of the bubble in the early 1990s; the banking system crisis and long period of deflation and stagnation of nominal GDP that ensued – the so-called "lost decade(s);" and a series of economic reform initiatives by, notably, the Hosokawa, Hashimoto, Koizumi and most recently Abe administrations, and associated or coincident societal change.

The Nikkei 225 stock market index went from a peak of around 39,000 (in December 1989) to a low of around 7000 (in March 2009), falling to just 18% of its peak level. Now the Nikkei 225 is around 21,500, still just 55% of its peak level. Compare this with the S&P500, which has increased 4.7 times in the same period.

Japan's GDP deflator, a broad measure of the price level associated with the economy's output of goods and services (GDP), is still 13% below its peak (recorded in Q2 1994). In the same period, the US GDP deflator is up by 59%. That's a 72 percentage point divergence in the overall price level between Japan and the US in a quarter of a century!

Now the three things that worry me about Japan as it enters the Reiwa era.

The first is earthquake risk. My family and I experienced the Great Hanshin Earthquake of January 1995, so there might be a subjective element in this assessment. I first went to Japan in December 1976 and can remember the reaction of friends and family at the time: "you are going to Japan? Tokyo is overdue for a major earthquake." That was probably not true,[1] but the fact remains that the Japanese archipelago is highly exposed to earthquake and associated tsunami risk, as the Great East Japan Earthquake of March 2011 only too tragically reminded the world. Earthquakes and tsunami, as well as causing serious loss of life, can do severe damage to the country's capital stock and cause major economic disruption.

Various dire assessments have been made of the risk of a major earthquake striking the densely populated eastern coast of the main Honshu island, such as there being a 70% chance of a magnitude 8-plus earthquake in the next 30 years. There is not a lot Japan can do about an exogenous event such as an earthquake other than prepare its physical and social infrastructure to withstand its impact and respond to its aftermath.

The second is China, and to a lesser extent Korea (both of them). Due to its large

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[1] This was likely a reference to the fact that 53 years had passed since the devastating Great Kanto Earthquake of 1923.

population (1.4 billion people) and its multi-decade rapid economic growth, China is now the second largest economy in the world (it is the largest, measured in PPP terms). If, as appears likely, China continues on its current economic development trajectory, it will become a formidable economic and geopolitical force to be reckoned with, and it is right on Japan's doorstep. Yet, for whatever reason, Japan and China, unlike Germany and France, have never come to terms with their fraught early- to mid-twentieth century history. Relations remain strained and, given their different political, economic and social systems, the scope for mutual misunderstandings to arise is high. As the global geopolitical power balance continues to shift, Japan will need to figure out how to manage its relationship with China (and to a lesser extent the two Koreas) in a way that does not inadvertently go off the rails.

The third thing that worries me about Japan is a bit more amorphous and subjective: it is that Japan, since the bursting of the bubble, appears to have become more insular and inward-looking and to not be engaging as actively as in the past with the rest of the world. Japan risks getting out of the global loop.

Japan is a very comfortable place to live and is a place where "everything works." Compared to much of the rest of the world, Japan is a haven of tranquility. Japanese students appear not to be going abroad to study with the same enthusiasm as in the past, particularly compared to Chinese and South Koreans, to the point where the Abe administration felt it necessary to launch a program in 2013 to double the number of students studying abroad by 2020 (from 60K to 120K for college students and from 30K to 60K for high school students).[2]

According to the UNESCO database, Japan was ranked in 23rd place, with 33,494 post-secondary students studying abroad in 2012. In this same year there were 698,395 students and 121,437 students studying abroad from China and Korea, respectively.

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[2] According to UNESCO data, in 2012 there were 33,494 post-secondary Japanese students studying abroad, compared with 698,395 for China and 121,437 for South Korea.

Why does this matter? One concern is that, as what Klaus Schwab has called the "Fourth Industrial Revolution" unfolds and economies become more knowledge- and software-based, Japan may be losing its technological edge, in areas where it now matters. It is not too much of a stretch to say that, given Japan's early technological leadership in electronics and in mobile phones and the penchant of Japanese for electronic gadgetry, "Apple" really should have been a Japanese firm.

But, as Brian Merchant's fascinating 2017 "biography" of the i-phone, *The One Device*, showed, developing such a device required diverse teams of creative thinkers and engineers bringing together and making work myriad different cutting-edge technologies. This is not something amenable to being done in an insular "mono-cultural" environment.

This is anecdotal and not scientific, but I took a look at the (29 page) technical paper for Facebook's mooted cryptocurrency, Libra, which has been gaining much attention lately (The Libra Blockchain). The paper lists no fewer than 53 co-authors, which says something about how collaborative such frontier-pushing ventures need to be. Of the 53 names listed, a full one-quarter (14) appeared to be Chinese (including of course possibly Chinese-American). None of the co-authors had Japanese names (nor were there any Korean-sounding names for that matter).

I would not want to overstate this concern: Japan is still an IP (intellectual property) power house. According to the World Intellectual Property Organization, Japan's share of worldwide patents in-force in 2017 was 15%, on a par with China, and not too far behind the US (22%). When it comes to new patents, however, Japan garnered 10%, the US 19% and China 44%.

Now, three things I don't worry about or don't worry about as much as other people seem to or in the same way.

The first is the "poor" state of Japanese corporate governance. It is a much more nuanced story than that.

There are two broad models of corporate governance: the “shareholder value maximization” model, which sees shareholders as the “owners” of the firm and managers as their “agents,” the canonical model of microeconomics and staple of business school pedagogy in the past, and the “stakeholder” model, which sees managers as mediating the interests of the various parties that make up the enterprise or have a stake in it, including their own. There is a long literature that associates “Anglo-American” corporate governance with the former model and Japanese (and Germanic) corporate governance with the latter.

A lot has changed in the corporate governance environment and rules of the game in Japan in the past three decades. A series of reforms has been implemented that can be viewed as nudging or pushing Japanese corporate governance away from the “stakeholder” model and towards the “shareholder value maximization” model. The cumulative import of these changes in significant.

Much attention has been paid to the fact that improving corporate governance has been one thrust of the “third arrow” of the Abenomics reform agenda, notably with the introduction of the Stewardship Code in 2014 and the Corporate Governance Code in 2015. But the story of corporate governance reforms goes back to the early to mid-1990s.

Here is a list of some of the major changes in the institutional rules of the game made in the second half of the 1990s: legalizing the holding company form of corporate organization, including financial holding companies; allowing firms to buy back their stock and to hold it as treasury stock; new laws and rules to allow stock swaps, corporate spinoffs and easier M&A activity; the introduction of stock options; the introduction of consolidated accounting as the disclosure standard, supplanting the traditional Japanese parent accounting standard; the introduction of US-style “committee structure” corporate boards, in which independent directors play a central role.[3] Over the course of five years or so, the tool-kit that Japanese managers had at their disposal to “supply” better corporate governance outcomes was radically transformed.

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[3] Full disclosure: I served as a non-executive director of ORIX Corp. from 2003 to 2010.

There were equally dramatic changes on the “demand” side of “better,” in the sense of more shareholder-value-oriented, corporate governance. This started with the opening up and deregulation of the asset management industry in the early 1990s, which used to be a monopoly of the trust banks and life insurance companies, and the associated emergence and increasing influence of arms-length investors, alongside the traditional “stable shareholders” (“antei kabunushi” in Japanese).

In tandem, there has been a steady unwinding of cross-shareholdings and a decline in the importance of the “main bank” system. In 1990, city and regional banks and non-financial corporations, together the mainstay of the cross-shareholding system, held about 46% of listed Japanese shares (by market value); by 2018 this was down to 25%. On the other hand, in the same period ownership by foreign investors rose from about 5% to 29%.

In the past quarter of a century, the cumulative changes in the “market for corporate control” as it exists in Japan add up to a dramatic transformation. Japanese managers now have a very different and much expanded corporate tool-fit and face much more potent pressures from investors to manage their companies well and with a keener eye on shareholder returns. However, to change longstanding corporate managerial behavior is a slow-moving process.

In 2000, I published a book in Japanese titled “Corporate Mega Restructuring; The Curtain Opens on a New Japanese Capitalism,” arguing that these changes presaged an accelerated pace of corporate restructuring ahead. I may have been twenty years too early with that call. I would not be surprised if Japan now is on the cusp of an era of much more active corporate restructuring.

Harking back to the earlier two models of corporate governance, there has been an interesting twist in recent years: with the emergence of ESG (Environmental, Social and Governance) investing, socially responsible investing, and impact investing, the West seems to have been moving away from the shareholder value model. These new investment approaches or philosophies gel more with a stakeholder model. In that context, the emerging Japanese hybrid model, as its stakeholder model incorporates a greater shareholder value orientation, may prove to be increasingly attractive to foreign investors, either in its own right or as an exposure or hedge in their portfolios.

The second thing I am not that worried about is Japan's demographics and aging society. Japan's population peaked at about 128 million in 2010 or so and is slowly declining. The government projects that, on certain baseline assumptions, the population is set to decline to around 87 million by 2060. Japanese are living longer, healthier lives, so the decline in population reflects a (total) fertility rate (1.43 in 2017) that has fallen well below the replacement fertility rate (2.07).

Why not worry? One should always be wary of long-term extrapolations. These are often very unreliable because they fail to take account of endogenous self-correcting forces, for example, an increase in the fertility rate (what goes down, can go up) (Japan's fertility rate bottomed at 1.26 in 2005). Policy can also intervene. Indeed, the Japanese government now has an official policy of trying to raise the fertility rate (to 1.8 by 2026) and of stemming the decline in the population to 100 million for the next 50 years. To have a shot at solving a problem, you first have to recognize it as one.

Also, it is far from clear that the presumption should be one of an ever-increasing population: it is growth in per capita income that matters for living standards, and this can and should keep rising, with technological innovation, even as the population declines. As people live longer healthier lives, they are also able to work longer too, making the projected rising dependency ratios look less scary.

But more than anything, I am much more positive about the scope for Japan to deal with its demographic challenges by embracing immigration. That Japan is closed to immigration or foreign workers today is largely a myth; that it will remain so in coming decades is almost certainly going to be proved wrong.

The number of foreign workers in Japan has been increasing at about 15% per annum in recent years. In 2018, there were 1.46 million foreign workers in the country, comprising about 2.2% of the workforce. This trend is likely to continue and have a snow-balling effect. The government is aiming to attract more foreign workers to ease the labor shortage that will attend a rising dependency ratio and has eased visa restrictions in order to do so.

Japan has ample scope to draw on foreign workers in its Asian hinterland. In 2018, 26.6% of foreign workers in Japan were Chinese, 21.7% were Vietnamese, 11.2% were from the Philippines, 8.7% were from Brazil, and 6.5% were from Nepal. The combined population of the five fastest growing source countries (Vietnam, Indonesia, Nepal, South Korea, the Philippines, in that order) is 537 million.

Japan has plenty of labor to tap and the economic pressures to do so will only build. Its challenge will be to figure out how to manage the process well for all concerned. Expect big changes in this area in coming decades.

The third thing that I don't worry about is Japan's fiscal situation and the risk of a fiscal crisis.

Japan is a rich country and is not about to go bankrupt. As a macro-economy, Japan consistently runs a current account surplus, which means net dissaving by the government is more than offset by net saving by the private sector. Japan's current account surplus in 2018 was 3.5% of GDP. That means Japan is a net lender to the rest of the world, not the other way around. Japan has been running substantial current account surpluses since the early 1980s, on average of close to 3% of GDP, which has allowed it to accumulate a large stock of net external assets: ¥341.6 trillion (US$31.0 trillion).

The BOJ pioneered quantitative easing (QE) (from March 2001 to March 2006) and, since April 2013, has been implementing quite an aggressive form of QE. In as much as it involves the central bank buying government debt securities, QE can be best viewed as a debt refinancing operation of the consolidated government (the government including the central bank) whereby it retires government debt securities and refinances them into central bank money (reserves). The key difference between regular government debt securities and central bank money is that the former has a maturity date, and in that sense, looks like it has to be repaid, whereas the latter does not. The central bank, and therefore the consolidated government, cannot default on the debt (money) it issues.

The BOJ currently holds ¥476.3 trillion of Japanese government securities, an increase of ¥351.0 trillion since it ramped up its QE in April 2013. This is almost half of total government bonds issued. The size of the BOJ's balance sheet is equivalent to 102% of GDP.

There is no technical limit on the ability of the BOJ, as an arm of the (consolidated) government, to keep doing this. Indeed, the BOJ's existing monetary policy stance is to "conduct purchases [of Japanese government bonds] in a flexible manner so that their amount outstanding will increase at an annual pace of about 80 trillion yen".[4]

On top of this, since September 2016 the BOJ has been implementing a policy of "yield curve control" as part of its QE, targeting the 10-year JGB yield to be around zero percent.[5] The BOJ has also committed to continue to expand the monetary base (without specifying an amount) until CPI inflation reaches and exceeds its target of 2% and "stays above the target in a stable manner".[6]

If the government, via the central bank, is able without limit to convert its debt securities into central bank money, which cannot default, and is able to set the yield on its ten-year debt at zero percent, in what sense is a fiscal crisis possible?

The usual argument against a central bank implementing such a policy is that it will cause inflation. But trying to raise the inflation rate is what the Japanese central bank and government have been trying to do for more than twenty years!

An upward inflation surprise in Japan would be most welcome and could happen.

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[4] In practice, the BOJ typically increases its JGB holdings by less than this, most recently (as of June 30, 2019) by ¥30.6 trillion compared to a year earlier.

[5] The other part of yield curve control is targeting the short-term (overnight) interest rate at minus 10 basis points.

[6] The latest reading for CPI inflation (May 2019) was 0.8% year-on-year.

All of the above said, a near-term concern is the government's planned hike of the consumption tax rate from 8% to 10% on October 1st of this year. The government should delay this (for third time), but this time tie the timing of its future implementation to the same condition that BOJ has set for continuing to expand the monetary base. That is, the government should commit not to raising the consumption tax rate until CPI inflation overshoots 2% and stays above 2%.

In conclusion, I will refrain from giving investment advice, but just note that, as it enters a new era, the Reiwa era, Japan represents an interesting investment story. Misunderstandings about Japan abound and, relatively speaking, not much attention is being paid to the world's third largest economy. I would observe that, whether it is the micro or the macro, a lot of pieces seem to be falling into place for something to happen in Japan. Let's hope it is something good.